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Before the

United States Senate Committee on Commerce, Science and Transportation
Subcommittee on Surface Transportation and Merchant Marine
On Surface Transportation Board Reauthorization
March 2, 1999

The Association of American Railroads (AAR) very much appreciates this opportunity to present our views regarding the reauthorization of the Surface Transportation Board (STB). AAR members include all of the Class I railroads in the United States as well as smaller railroads, major freight railroads in Canada and Mexico, Amtrak, and some commuter railroads. In all, AAR members account for 93 percent of the railroad industry's freight revenue, 91 percent of its employees and 76 percent of its route mileage.

U.S. freight railroads move approximately 40 percent of the freight, based on ton-miles, and proudly employ some 200,000 people.

The AAR strongly supports legislation introduced by Senators McCain, Lott and Hollings — S.98 — which provides for a multi-year reauthorization of the STB. AAR opposes any imposition of additional user fees. So long as railroads are regulated under the Interstate Commerce Act, there is need for an independent agency such as the Surface Transportation Board to perform that task, and such regulatory functions should be funded primarily through general appropriations.

Any other substantive changes to the underlying statute would best be considered separately. However, for a variety of reasons, which I will explain, the AAR opposes proposals to undo the careful balance between shipper interests and railroad interests that is the central focus of the Staggers Act. We believe that the Board today has ample authority to deal with service problems and rate issues.

There is no reason to mandate one-sided change. Over the years, the STB has rendered many decisions with which we have disagreed . . . decisions that required railroads to pay tens of millions of dollars to shippers in settlement of rate cases; that restrict the defenses railroads can use in rate cases; and that could impair efficient service by imposing regulatory restrictions on what should be management decision. We are seeking reconsideration of some of those decisions. But this clearly shows that this agency is not shy about using its extensive powers to protect rail users.

You will hear from some shipper representatives who would like to see massive changes in the way railroads are regulated. And you will hear about bad service and lost business opportunity. We acknowledge the seriousness of the problems faced by our customers during the latter part of 1997 and the first half of 1998. As an industry, we take those problems very seriously and we have moved very forcefully to resolve them. Our five customer outreach meetings held across the country and the subsequent decision to become the nation's first industry to publish weekly performance measures on the Internet are evidence of our commitment to our customers' needs (See Appendix A for a report on our response to STB Ex Parte No. 575's order regarding customer communications). We have held other meetings with a wide range of customer groups, including the National Industrial Transportation League, the Chemical Manufacturers Association, the National Mining Association, the American Farm Bureau Federation, the Edison Electric Institute, the National Grain and Feed Association and more. Our commitment to customer service included more than communications, however. It also meant spending a record $7.5 billion on capital improvements last year. We believe the problems of 1997-98 are behind us now, but we are committed to continued improvements in our service.

As you hear requests for regulatory changes, however, please ask yourselves this question: could additional regulation have resolved those problems more efficiently? As service problems confirm, there is a greater need than ever for expanded capacity and improvement in the rail infrastructure.

The actions needed to resolve the problems of 1997 included additional capital spending, increased hiring, and critical analysis of operations to implement necessary changes as required. And that is what the railroads did. They corrected past mistakes through concrete actions.

That $7.5 billion we spent on capital improvements last year represented an impressive 20 percent increase over the previous record for single year capital spending, as track was upgraded, signaling and communications systems were enhanced, and hundreds of locomotives and thousands of freight cars were added to equipment fleets.

A truly pivotal change occurred last year when for the first time in more than a decade, railroads began to increase their employment levels from prior years. The Railroad Retirement Board reports that railroad industry employment levels were up 2 percent from 1997 levels at the end of October and ran consistently ahead of year-earlier levels throughout 1998.

Operational changes likewise were instituted to relieve congestion and better coordinate operations among carriers and between railroads and rail customers. One such change established a joint dispatching center to handle Union Pacific and Burlington Northern Santa Fe operations in the Texas/Gulf Coast area. That was so successful that additional joint dispatching centers are planned elsewhere.

In addition, we worked very closely with our customers to improve traffic flows by spreading out intermodal volume among more ports and over longer periods of time and to gain more accurate forecasts of when and where traffic surges could be expected. The agriculture summit held last summer in Kansas City likewise improved communications between railroads and agricultural interests so that railroads were better prepared and their customers were also. The addition of regional grain desks by western railroads was helpful to farmers in predicting grain demand and responding to changing market conditions.

As evidence of our success in resolving earlier problems, I would point to the rail industry's performance during the fall of 1998. There were many predictions that railroads would be unable to meet the twin demands of a record grain harvest and an influx of containerized imports for Christmas. But we met both challenges handily. During October and November, U.S. railroads moved almost 10,000 more grain cars than they did during the same months in

1997. Intermodal traffic increased by 26,000 trailers and containers also during October and November. At the same time grain and intermodal volume was growing, so was other rail traffic. During those same two months, this other rail freight traffic increased by more than 70,000 carloads. We moved this influx of business without serious problem.

Donald J. Schneider of Schneider Transport, the nation's largest truckload carrier, recently wrote: "Because of dramatically improved rail service, Schneider is planning over 20 percent growth in intermodal for 1999." Ed Emmett, president of the National Industrial Transportation League, told the Journal of Commerce: "They (the railroads) rose to the occasion."

In November, Tom Tunnell, president of the Kansas Grain and Feed Association told the Associated Press: "The rail transportation industry was clearly prepared for this year's bin-buster harvest and, in turn, played a significant role in limiting the number of bushels stored in emergency structures or on the ground. Our staff consistently heard reports of vastly improved rail service during the harvest crunch."

Obviously, depressed grain prices had an impact on grain transportation, as storage levels remained high and, as a result, we weren't called upon to move two bumper harvests at once. Had that occurred, the entire grain logistics chain — not just railroads, but also trucks, barges, ports and processors — would have been hard-pressed to keep up with demand.

The fact remains, however, that railroads moved more grain during the fall harvest in 1998 than they did during the difficult 1997 season, and did it without serious problem.

It is our intention to build upon these improvements and to provide even better service in the future.

I would now like to address the changes that have occurred in the railroad industry since the Staggers Rail Act of 1980 was enacted. The Congress of the United States chose then to partially deregulate the railroads in order to strengthen an industry that was rapidly and literally falling apart.

The Staggers Act has achieved exactly what Congress intended when it was passed. Today's railroads are stronger, more efficient, more productive, more economical and more competitive than at any time in the past.

Two of the key elements in Staggers were freedom to price and freedom to enter into contracts. Market-based — or differential — pricing permits railroads to price different segments of the market according to demand. This is what most businesses do. But railroads were very limited in their ability to do so prior to Staggers. The freedom to contract was likewise critical. Before Staggers, railroads could not enter into contracts in which they made price and service level commitments in exchange for volume commitments. Today, some 70 percent of all rail freight moves under contract.

Railroad customers have benefited from average rate reductions of 55 percent on an inflation-adjusted basis since 1981. These reductions have benefited all commodities moving by rail. For example, average coal rates have declined by 57 percent on an inflation-adjusted basis since 1981. This is doubtless one of the reasons that average electric rates declined by 26 percent on an inflation-adjusted basis over that same period. Average rail rates for wheat have fallen by 56 percent since 1981. The price of bread curiously has declined by just 3 percent on an inflation adjusted basis since then. (See Charts 1 and 2 at the back of this testimony.) Rate reductions of the magnitude seen in the railroad industry are not the actions of an industry with a stranglehold on its customers.

Railroads face ever-increasing competition for all categories of rail freight, not only among themselves but from other transportation modes.

Trucks carry almost 46 percent of intercity tons and earn 78 percent of intercity freight dollars. By virtue of their mobility and use of public highways, trucks reach all origin/destination points that railroads serve, as well as points inaccessible to rail.

Bulk commodities — once thought of as rail-dependent — often move by truck. According to the U.S. Department of Agriculture, 40.6 percent of grain moves by truck, compared with 40 percent by rail and 19.4 percent by barge. A significant amount of coal in the Appalachian coal fields begins as a truck movement from mine to tipple. That coal is trucked to multiple tipples, often served by different railroads. In the same way, grain is trucked to different elevators served by different carriers and soda ash mined along one railroad is trucked to transload centers on a competing railroad.

Indeed solely-served rail facilities can truck a wide range of commodities, from steel to lumber to canned goods, to transload facilities served either by a rail competitor or a barge. Shippers located near major navigable waterways enjoy barge competition for coal, chemicals, grain and steel. Pipelines provide competition for railroads in serving energy users, delivering oil and natural gas that may be substituted for coal.

In all, railroad competitors account for more than 90 percent of the freight transportation dollar in this country.

Railroads, in fact, face competition for almost everything we haul. And if our industry is to grow, we must be able to compete effectively in a market where our customers already have many transportation options. But if we are to do that successfully, there are three principles that we must follow.

1. North America's economic future and its ability to compete in world markets is best served by a freight railroad industry that provides excellent service at reasonable rates and a safe working environment for its employees.

Railroads have achieved much success since 1980 by reducing costs and becoming more efficient. But further success will require growth in the "top-line." In other words, we have to " grow the business," and that means we have to provide better service.

We are striving to do this. Last year, railroads held a series of customer outreach meetings in which we discussed a number of issues that would help us serve our customers better. One result of those meetings is that railroads became the first industry to publish weekly performance measures on the Internet. We are continuing our dialogue with rail customers this year. We will shortly hold another meeting with rail customers — this one in Chicago — where we will address issues relating to customer communications over the entire cycle of a shipment, from the time a car is ordered until it is delivered, including problem resolution.

Also as a result of our customer outreach efforts, we have agreed to accelerate development of an Interline Service Management business plan. As much as 40 percent of our revenue involves shipments moving over more than one railroad so anything we can do to improve the handling of these interline moves will have a direct impact on the quality of service.

Nearly two years ago, the industry developed NetREDI — an Internet-based means by which railroad customers can trace their individual shipments. This is now being used on a daily basis by our customers. Our customer-service centers provide around-the-clock assistance for those who ship by rail.

Last year railroads reached a landmark agreement with the National Grain and Feed Association to arbitrate service issues and mediate rate disputes. We even adopted, in total, NGFA's own century-old arbitration system.

Railroads also resolved to work better with each other, including an historic agreement between the Class I railroads and the American Short Line and Regional Railroad Association that will mean better service for the customers we cooperatively serve.

Staggers helped us achieve our goal of providing customized, efficient, economical and safe service. Since 1980, average rates have declined by 55 percent on an inflation-adjusted basis.

Just as remarkable has been the improvement in railroad safety. Both train accident and employee injury rates have declined by 70 percent since 1980. (See Chart 3 at the back of this testimony.) Railroad workers have lower injury rates than their counterparts in the truck, aviation and transit industries. Indeed, their injury rate is lower than the average for manufacturing as a whole. (See Chart 3A at the back of this testimony.) Staggers had everything to do with this as it increased cash flow, providing railroads with the money needed to eliminate deferred maintenance, upgrade track and purchase new and safer equipment.

2. Investment and re-investment are fundamental to providing world-class service. The ability of our industry to attract the capital it needs to maintain and improve service is essential to our continued viability and success.

Railroads are the second most capital intensive industry in the United States with only the various segments of the financial services industry requiring a larger asset base to generate a dollar of revenue. According to FORTUNE Magazine, railroads require an asset base of $2.48 to generate just one dollar of annual revenue.

This is far more than our customers or our competitors. Utilities, on average, need $2.35; mining, $1.49; chemicals, $1.10; and trucking companies, just 48 cents.

Because we are privately-owned, we are responsible for the full cost of maintaining and improving our infrastructure. Last year, it cost us almost $9 billion just to maintain and improve our tracks and signaling systems.

Railroads have spent more than $230 billion since 1980 to maintain and improve infrastructure and equipment. Railroads have put a higher percentage of revenues back into capital improvements than any other industry in the United States since 1990.

But these improvements have paid off for us and for our customers. Productivity of track, freight cars and locomotives has doubled since 1980, and labor productivity has tripled. Especially striking is a comparison between the railroad industry's performance during the 15 years before Staggers and during the 18 years since. The industry was essentially stagnant in terms of productivity, volume, rates and revenue prior to Staggers. Since Staggers, productivity and volume have both risen substantially while revenue and average rates have actually declined on an inflation-adjusted basis.   (See Chart 4 at the back of this testimony.) That turnaround was made possible only because railroads were able to invest more money after deregulation.

But just to maintain our current share of the freight transportation market, railroads will have to increase capital spending substantially. How much? We will need to invest a stunning $162 billion in capital between now and the year 2020. This is in addition to the more than $200 billion we will need to spend just to maintain our current system. That is more than twice the industry's investment base. (See Chart 5 at the back of this testimony.)

Our ability to continue investing at this level would be crippled by proposals to transfer revenue from railroads to some of our customers through reregulation. Already our rate of return is below our cost of capital. During 1997, our average rate of return on net investment was 7.56 percent. This was certainly far better than the 1 or 2 percent that was typical of the 1970s. But it remains well below the railroad industry's cost of capital, which was 11.8 percent.

Some people have objected to using the standard of "cost of capital" for judging revenue adequacy of the railroad industry. So last year we accepted a proposal from Alfred Kahn who — on behalf of the Alliance for Rail Competition — recommended that a panel of experts be created to determine if there was a better method of measuring railroad revenue adequacy.

We no sooner accepted the proposal than those who proffered it walked away from it.

The fact is that no matter what standard is used, railroad industry earnings remain below those of other industries. In 1997, railroads reported a return on equity of 10.4 percent. The average for Fortune 500 companies was 13.9 percent. Railroads ranked 30th out of 37 industries in terms of return on equity. (See Chart 6 at the back of this testimony.)

Railroad stocks have underperformed the market. The average ratio of price to earnings for railroad stocks was 16.5 in 1997. The average for the Standard & Poors 500 was 27.5. One brokerage house removed its "buy" recommendation from railroad stocks last year after the threat of reregulation gained credibility.

Reregulation would make it impossible to make the needed future investment for our customers. We would not have the funds to grow our industry —not even to maintain it, and the system would inevitably shrink with declining service (especially to small communities), worsening safety and decreasing employment.

Don't just take our word for it. Leading Wall Street analysts have testified before Congress that reregulation would cripple the railroads' ability to raise capital. Last year, for example, Stephan C. Month of Credit Suisse First Boston talked about the impact of reregulation on railroads and told a House subcommittee: "The greater the limitations on the industry's ability to grow revenues and cut costs, the costlier Wall Street financing will become and . . . the more difficult it will be for railroads to earn their cost of capital and remain economically viable."

3. The third principle is that market forces should determine rates, and the private sector should remain the source of capital for our investment needs. Railroads should be run by railroaders, not bureaucrats.

Those proposing changes don't like the word "reregulation." But that is exactly what they are proposing.

Forced access would bring about a huge influx in regulatory proceedings. Washington would decide who would gain access. Washington would set prices on how much they would pay to gain access. Washington would decide operational disputes that would arise when two or more railroads wanted to use the same piece of track at the same time. The incentive for and ability of the railroads to invest in infrastructure would disappear.

What proponents of reregulation are really proposing is something akin to forcing one newspaper to let another one use its printing presses, with press schedules, rental fees and operational disputes decided by a government agency. Or one chemical company letting another use its patents, with a government agency deciding all terms and conditions. And who would invest in new research and products under these circumstances?

I doubt that anyone would seriously suggest that one utility should be permitted to use another's generating plant at marginal costs, or one chemical company to use a rival's at marginal cost. The only way access can be considered market-based is if it reflects full value that is lost by the owner when it must share the asset. But not a single proposal for access includes such charges. The reason is clear: access at full value would not reduce rates for shippers.

Proposals for eliminating so-called "bottlenecks" likewise would expand the scope of regulation and substantially increase the workload of the STB. Such proposals would also bring back some of the problems of the past, such as inefficient routings that reduce efficiency and increase costs.

Reversing the bottleneck decisions would be like letting the government determine how best to run the railroad, determining where and how to invest in track. But first the government would have to buy the track, and then determine how to pay for it. Using last year's numbers, the cost of maintaining a government-run track system would be about $9 billion, the equivalent of new fuel taxes of $1.94 per gallon of fuel used by railroads. This is far greater than any highway fuel taxes.

The real objective of these proposals is not competition, but rather lower rates in the short term by ending the practice of market-based pricing. Yet most businesses engage in this same practice. Utilities, for example, may charge different rates at different times of the day. Movie theaters offer discounts for weekday matinees. Restaurants offer early bird discounts.

These businesses practice market-based pricing to spread out fixed costs among more customers. And that is why railroads also use it.

If the government forced railroads to engage in average cost pricing, rates for some customers might go down initially. If railroads attempted to compensate for this by increasing rates for other customers, those with more competitive options would divert their business away from rail. Fixed costs would then be spread among fewer and fewer rail customers. If such a policy were allowed to play itself out, the final chapter would find that only shippers with no alternative to rail would remain, and their rates would soar since they would have to pay the entire cost of the rail system.

Donald Schneider of Schneider National put it best when he said: "The marketplace and not reregulation is the best determinant of the particular mode, and reregulation of rail would be detrimental to logistics' productivity."

The present freight rail system in the U.S. works. Indeed, it has become the model for countries around the world. According to World Bank statistics, U.S. freight railroads move more freight, more efficiently and more economically than do railroads in Western Europe, in Japan or any other place in the world.

I know it is customary for industries faced with change to come before Congress and predict disaster. But the railroad industry is different in one important respect. Prior to 1980, we lived through the consequences of what is being proposed and it took an act of Congress and nearly 20 years for this industry to regain its footing. The health and vitality of our economy depends on the efficiency of our nation's transportation system. Why jeopardize the future of our nation's economy by reregulating railroads?

The railroad industry of two decades ago was a capital-starved industry. Some twenty percent of the industry sunk into bankruptcy during the 1970s. Return on investment was under two percent. Accident rates were soaring. Average rates were climbing faster than inflation. Market share was declining. The government was pouring $1 billion a year in direct subsidy to keep Conrail running, and there was discussion of nationalizing the railroads. Can you imagine the line item for railroads in the budget today had that happened?

Fortunately, that did not occur and with passage of the Staggers Act in 1980, Congress gave the industry the opportunity to find solutions in the private sector.

That is why the Congress of the United States in 1980 passed the Staggers Rail Act. And that is why this Congress must not change it.

Finally, AAR supports sufficient funding and staffing for the STB to ensure that it can carry out its responsibilities in an effective and timely manner. The Administration's proposal in its FY 2000 budget submission to fully fund the STB's $17 million budget through user fees threatens that goal.

The majority of costs associated with the STB's regulatory activities most appropriately are borne by the public through a general appropriation, because the primary beneficiary of STB activities is the public.

Congress rejected the Administration's proposals to fully fund through user fees the STB's operations in Fiscal Years 1997, 1998 and 1999, after noting virtually unanimous opposition from railroads <u>and</u> rail customers. Congress provided the majority of the Board's funding through a general appropriation, with modest additional funding generated by user fees. AAR urges Congress to take the same approach in FY 2000.